

San Diego, California; Appropriations; General Obligation

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San Diego Mtdb Auth, California		
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San Diego Mtdb Auth (San Diego) 2003 lse rev rfdg bnds (San Diego Old Twn Lt Rail Transit Extension Rfdg)		
<i>Unenhanced Rating</i>	A-(SPUR)/Stable	Outlook Revised
San Diego Pub Facs Fincg Auth, California		
San Diego, California		
San Diego Pub Facs Fincg Auth (San Diego) lse rev rfdg bnds ser 2007A		
<i>Long Term Rating</i>	A-/Stable	Outlook Revised
San Diego Pub Fac Fing Auth lse rev bnds (Fire & Life Safety Fac Proj) ser 2002B (MBIA of Illinois)		
<i>Unenhanced Rating</i>	A-(SPUR)/Stable	Outlook Revised

Rationale

Standard & Poor's Ratings Services revised the rating outlook to stable from positive on San Diego, Calif.'s general obligation (GO) bonds, lease revenue bonds, and certificates of participation (COPs). Standard & Poor's also affirmed its 'A' rating on the city's GO bonds and its 'A-' rating on the city's lease revenue bonds and COPs.

The rating on the city's lease revenue bonds and COPs reflects our view of the city's general credit characteristics and its covenant to budget and appropriate annual lease payments for various properties' use.

The GO bond rating reflects our view of the city's general credit characteristics, which include the city's:

- Practice of multiyear forecasting, which has allowed the city to identify future fiscal imbalances in time to develop and implement solutions;
- Reserves that are projected to remain at good levels even after expected drawdowns to balance the budget for fiscal 2010 and the recent adoption of plans to eliminate the significant shortfall that had been projected for fiscal 2011; and
- Strong long-term economic fundamentals despite vulnerability to the economic downturn during the last year, including its role as the anchor and center for the majority of employment in the county, and what we consider strong household incomes and per capita property values.

These credit strengths are tempered by our view of the city's:

- Limited revenue-raising flexibility and budget pressures that we expect will continue despite the early adoption of gap-closing plans six months in advance of the start of fiscal 2011. Among the budget challenges, in our view, is the city's plan, which is in part contingent on completing certain labor negotiation processes, to use one-time solutions, including some deficit financing, to offset a portion of the city's fiscal 2011 projected general fund deficit;

- Significant deferred maintenance needs and pension and other postemployment benefits (OPEB) liabilities, which we believe could either contribute to future budget pressure or constrain the city's ability to fully eliminate its structure deficit, especially if negative revenue trends continue.

According to city estimates, fiscal 2009 general fund results include an unreserved undesignated general fund balance equal to what we consider a good 7.7% of revenue, after a \$10.4 million (1% of expenditures) deficit. The general fund deficit is after net transfers of about \$81 million, which is about \$32.5 million more than in fiscal 2008. Although estimated general fund results maintain what we consider good fund balance levels, a slowing economy has resulted in continued downward revisions to the city's revenues beginning in fiscal 2009. The city lowered its fiscal 2010 revenue projections after the fiscal 2009 fourth quarter and fiscal 2010 first quarter forecasts by about \$22 million and \$28 million, respectively. In our opinion, this shortfall would have been deeper if not for an increase in the city's forecasted property tax revenue, its single largest general fund revenue source. Assessed value (AV) is \$180.8 billion for fiscal 2010, which reflects a 13.7% increase over the prior year instead of the 1.5% decline the city had previously expected.

The mayor's five-year outlook (fiscals 2011-2015), released in October 2009, identified a \$179.1 million general fund deficit for fiscal 2011, which would b would continue through fiscal 2015 absent expenditure reductions or revenue enhancements. According to management, the annual deficits are not cumulative; if the deficit were eliminated in year-one, the out-year deficits would also be eliminated. The city council recently adopted the mayor's proposed fiscal 2011 budget. The proposed budget includes about \$24.6 million of savings achieved during fiscal 2010 to be set aside for use in fiscal 2011. The plan generally eliminates the deficit with \$96.5 million of one-time solutions and \$82.6 million ongoing expenditure reductions, according to the city. According to management, one-time solutions include a \$27.5 million deferral of contributions to the city's general fund, workers compensation, and public liability reserves to meet targets established under a city council-adopted policy. The budget proposal maintains the general fund reserve at 7% instead of the 7.5% target set forth in the policy for fiscal 2011. The reserve policy sets a target to reach a combined emergency, unallocated, and appropriated general fund reserve equal to 8% of general fund revenue by fiscal 2012. In our opinion, it would likely be very difficult for the city to achieve its 8% target by fiscal 2012 if it is unable to find offsets for the \$96.5 million of one-time budget solutions and if revenues deteriorate further. Additionally, the budget amendment calls for debt financing the McGuigan Settlement, related to the under-funding of the pension system, for a net on-time savings of \$25.2 million, after deducting the city's projected annual debt service. Other solutions included \$19.6 million of what the city labels as revenue solutions, including \$13.8 million of transfers in or release of undesignated fund balances, which it also counts among the one-time solutions. Ongoing solutions include the reduction of about 200 employees and elimination of about 330 currently vacant positions. The mayor's fiscal 2011 proposed general fund budget, according to the council resolution, is to serve as a flexible framework for the full annual budget, which is to be submitted by the mayor no later than April 15, 2010. Additionally, the council's adoption of the proposed budget is contingent upon completion of certain statutory meet and confer requirements under state code. According to management, only one bargaining unit remains unsettled, and it is unclear when labor negotiations would be resolved.

The council's recent budget actions address only the fiscal 2011 budget. The city states that it may make midyear fiscal 2010 budget adjustments after the revenue forecast is updated in January. In a report released November 2009, subsequent to the mayor's five-year outlook, the city revised its fiscal 2010 general fund revenue projections downward a second time since budget adoption by an additional \$28 million, for a total shortfall of about \$50

million. We believe the \$28 million of additional revenue shortfall would be in addition to the \$179 million fiscal 2011 deficit should the city be unable to fully eliminate the fiscal 2010 deficit due to currently projected one-time gap closing measures. The fiscal 2010 revenue shortfall is shown in the November 2009 report to be partially offset by liquidation of \$31.5 million of prior-year carry-forward appropriations, for a projected deficit (or fund balance drawdown) of \$7.5 million, resulting in an ending unreserved general fund balance of 6.49% of city-projected general fund revenue (\$1.079 million). It is uncertain how the city would address what we view to be significant future budget pressures, including exposure to possible further decline in revenues and mitigate the \$96.5 million of one-time solutions for fiscal 2011, without relying on the use of the fund balance or management's expectation of a rebound in economic activity to bolster future revenue.

We consider San Diego's management practices "good" under our Standard & Poor's Financial Management Assessment (FMA) methodology, indicating our view that practices exist in most areas, although not all may be formalized or regularly monitored by government officials.

San Diego's population of 1.3 million in 2008 has risen about 1% per year since the 2000 U.S. census. The city is a significant employment center within the county, representing about 45% of the county's total employment. The economy consists of various high-tech clusters, including biotech and telecommunications, combined with a reliance on tourism and the military and defense industries. The city's economic base is also anchored by higher education and major scientific research institutions, including the University of California-San Diego, San Diego State University, Scripps Research Institute, the Salk Institute for Biological Studies, and the San Diego Supercomputer Center. Median household effective buying income is also strong, in our view, at 117% of the national average in 2008. However, given rising unemployment rates this ratio may have moderated over the past year. According to the California Employment Development Department, the city's unemployment rate has grown gradually from an annual average rate of about 4% in 2006 to a monthly rate of more than 10% between June and October 2009. Rates are not seasonally adjusted.

In our view, overall net debt is a moderate \$3,952 per capita and a low 2.9% of fiscal 2010 market value. On a per capita basis, the city's market value is extremely strong, in our opinion, at approximately \$135,237, based on fiscal 2010 AV. According to management's estimates, the city's general fund deferred maintenance needs total between \$800 million and \$900 million, for which the city issued about \$103 million of lease revenue bonds in March 2009; we understand that the city expects to use additional debt financing in fiscals 2011 and 2012. Debt service carrying charges, for all governmental funds, represented what we consider a moderate 9.3% for fiscal 2008.

Outlook

The stable outlook reflects our view of the city's practice of long-term financial forecasting, which contributes to the "good" FMA. The outlook also takes into consideration our view of management's proactive efforts to address a significant projected deficit in fiscal 2011 by maximizing 18 months of budget savings. It also recognizes our view that the city's budget pressures have not been fully resolved and will require continued substantial efforts to develop solutions to offset use of one-time solutions and potential exposure to further erosion in key general fund tax revenues given the city's double-digit unemployment rate. Additionally, in consideration of deferred reserve contributions and council's willingness to amend its reserve policies, maintenance of the current rating will depend partly on our view of the city's ability to successfully balance its budget without spending down reserves to a level that no longer provides what we consider to be sufficient budget cushion for unexpected fiscal needs and cash flow.

The rating may be lowered if budget pressures are not abated with what we consider to be sufficient long-term recurring revenue and/or expenditure alternatives and the city's budget deficits are no longer in our view reasonably sustainable with one-time fixes.

Retirement Benefits

Since fiscal 2006, the city has made the annual required contribution (ARC) to the San Diego City Employee Retirement System (SDCERS); as investment earnings have improved, the funded ratio improved to 78.8% in fiscal 2007 and 78.2% in fiscal 2008 with an unfunded actuarial accrued liability (UAAL) of \$1.3 billion, which is equal to about 243% of covered payroll. For fiscal 2010, the city had estimated the general fund portion of the contribution to be \$125 million, or what we consider a large 11% of the adopted budget expenditures. The mayor's five-year outlook shows the fiscal 2011 general fund required pension payment will increase by \$57 million to equal about 15% of the outlook's forecasted general fund expenditures. The savings from recent negotiations to change to certain retirement system benefits and recent salary freezes have not yet been incorporated in the actuarial valuations, according to the city. Additionally, we understand that certain retirement benefits remain a source of contention between the city and some current and retired employee groups in and out of the courts.

In 1996 and 2001, the city entered into agreements with SDCERS that allowed the city to make pension contributions at rates below the required funding levels, even while pension benefits were increasing. The city's actual contribution to the system from the general fund in fiscal 2003 was \$42 million, or 5.6% of general fund expenditures. As system underfunding continued and investment returns declined, the pension system's total UAAL increased to, in our view, a large \$1.3 billion and the funded ratio fell to a low of 65.8% in June 30, 2004. In 2004, voters approved a city charter amendment that would require the majority of SDCERS board members to be independent of the city, and to eliminate negative amortization by using a 15-year amortization period actuarial assumption beginning in fiscal 2009. SDCERS board has chosen to use a 20-year amortization period, down from 27 years. The longer smoothing period of 20 years compared to 15 years lowers the city's annual contribution, in our opinion. In 2006, voters approved a city charter amendment that requires future voter approval for any increases in certain retirement system benefits.

The city also provides limited retiree health benefits per year to employees who retired after July 1, 2005, and before Oct. 6, 1980. City employees who were hired after Oct. 6, 1980, through July 1, 2005, receive health care benefits upon retirement that are in our view significantly higher than the aforementioned group's benefits. The city's OPEB was actuarially valued at \$1.3 billion and the city has chosen to fund the obligation on a pay-go basis, with some prefunding. The general fund OPEB pay-as-you-go contribution for fiscal 2011 is \$43.2 million, and would be an additional \$40.4 million if funding the ARC to fully fund its future liability.

Financial Management Assessment: 'Good'

We consider San Diego's management practices "good" under our Standard & Poor's FMA methodology, indicating our view that practices exist in most areas, although not all may be formalized or regularly monitored by government officials. The city council generally performs formal budget amendments during the midyear and year-end reviews; in addition, the comptroller publicly posts and presents monthly reports on actual general fund performance to the city council's budget and finance committee. In November 2006, the city prepared its first long-term financial outlook, which projects general fund operations, revenue and expenditure trends, and future

budgetary gaps for the next five years, although potential salary increases are not included in the projections. The city reviews its formal investment policy annually and presents monthly reports on investment holdings and average yield to the city council. The city adopted a formal debt management policy in November 2007 that includes maximum debt burden thresholds for GO and lease revenue debt, as well as minimum coverage level targets for revenue bonds. Although the city council also adopted a reserve policy with minimum funding requirements and targets, the mayor recently proposed, and the city council approved, deferral of achieving these targets. The targets included a combined emergency, unallocated and appropriated reserve equal to 8% of general fund revenue by fiscal 2012; the emergency reserve, to be used as a contingency for natural disasters or unforeseen catastrophic events, requires a minimum 5% of general fund revenue and requires a two-thirds council vote to access the reserve. Management has also identified deferred-maintenance needs and funding plan in the five year financial outlook.

Related Research

- USPF Criteria: "GO Debt," Oct. 12, 2006
- USPF Criteria: "Appropriation-Backed Obligations," June 13, 2007

Ratings Detail (As Of December 23, 2009)		
San Diego rfdg certs of part (Balboa Pk & Mission Bay Pk Cap) ser 1996B		
Long Term Rating	A-/Stable	Outlook Revised
San Diego GO Bnds (Pub Safety Comm Proj) ser 1991		
Long Term Rating	A/Stable	Outlook Revised
San Diego 2003 certs of part (1993 Balboa Park/Mission Bay Pk Rfdg)		
Unenhanced Rating	A-(SPUR)/Stable	Outlook Revised
San Diego Convtm Ctr Expansion Fing Auth, California		
San Diego, California		
San Diego Convtm Ctr Expansion Fing Auth lse rev bnds ser 1998A		
Unenhanced Rating	A-(SPUR)/Stable	Outlook Revised
Many issues are enhanced by bond insurance.		

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